

**Critical Analysis of “On the Subject Matter of Water and Sewer:
Based on Advisories from Town Counsel and the Town Accountant”
as presented to the Natick Board of Selectmen by Jeffrey Phillips on 8/8/05**

Voted and approved by the Natick Finance Committee by a vote of 11-0-1 on September 6, 2005

Summarizing Mr. Phillips’ concerns

Mr. Phillips presented an analysis of MWRA assessments as a percentage of MWRA billings and pointed to a net difference of \$6,478,334 [ed - \$6,552,068 based on Mr. Phillips’ memo of 8/9/05] as an indication that rate payers are being overcharged for sewer services.

“There can be no justification for the ratepayers being charged an additional \$36.70 [ed – Mr. Phillips has amended this note to make the number \$37.12] for every \$100.00 of actual cost to the Town for the MWRA assessment. The Board of Selectmen, as water and sewer commissioners for the Town of Natick, owe the ratepayers an explanation for how this was allowed to happen and what they propose to do to correct it.”

-Jeff Phillips, 8/8/05 memo to Board of Selectmen, page 4

In his memo, Mr. Phillips suggests that there was no justification for including allocated costs in setting water and sewer rate schedules prior to the formation of the water and sewer enterprise fund:

“..there is no need to argue pointlessly about the allocated costs that were incurred by the Town for the operation of the water and sewer division of the Department of Public Works. Prior to the advent of the Water and Sewer Enterprise Fund on July 1, 2002, there was no statutory justification for designating costs as allocated”

-Jeff Phillips, 8/8/05 memo to Board of Selectmen, pages 1-2

Explanation of allocated costs related to delivering water and sewer services

In contrast to Mr. Phillips’ assertion that “there is no statutory justification for designating costs as allocated” prior to the creation of the enterprise fund, the evidence shows very clearly that the Town of Natick considered allocated costs each year in setting water and sewer rates as a matter of prudent business practice.

Our examination of total costs of delivering water and sewer services from 1998 to 2002 shows that allocated costs have consistently been factored into rates, even prior to the establishment of the enterprise fund. For example, debt service typically added around 20% above direct costs.

Using the parlance of Mr. Phillips’ analysis, an additional \$20 of every \$100 of “actual cost” to the Town is used to pay down debt from water and sewer capital projects. If this additional \$20 were not added to every \$100 of “actual cost” then there would not be money available through water and sewer revenues to pay down debt related to water and sewer projects.

A complete cost analysis for costs from FY98 through FY02 is presented in Table 1 in the back of this document..

The allocations for debt service, equipment maintenance, engineering services, DPW administration, and highway maintenance alone account

for the 36% “overcharge” alleged by Mr. Phillips.

In his testimony in front of the Budget Planning Subcommittee of the Natick Finance Committee, Mr. Phillips pointed to highlights of Board of Selectmen meeting minutes as evidence that indirect, allocated costs were never considered prior to the creation of the enterprise fund. However, he ignored contradictory statements in the same meeting minutes that indicated indirect costs were considered. For example:

“Finance Director Robert Palmer was asked to explain the water & sewer enterprise fund and how it would work. He noted that basically the Town was operating as an enterprise fund...”

Mr. Palmer noted that one question from Moody’s when they did the bond rating was why there wasn’t an enterprise fund and that was one reason he looked into it. The Department of Revenue has said that the Town was running it as an enterprise fund and should establish it as an enterprise fund.

In a memo to the Board, Mr. Palmer listed the revenue from water & sewer as well as the direct and allocated expenses.”

-Board of Selectmen meeting minutes 3/18/02, page 7 of 11 (emphasis added)

Further to this point, the Budget and Planning Subcommittee heard testimony from Finance Director Palmer that he has long considered indirect costs in estimating the costs of providing water and sewer services. The introduction of the enterprise fund had the effect of formalizing this policy and process.

Mr. Phillips’ current analysis ignores the Town’s long-standing practice of including allocated expenses when considering rate setting for water and sewer services. Mr. Phillips focuses on the MWRA assessment costs and MWRA rate revenue. He isolates \$17.6MM of MWRA assessment costs and compares this to MWRA rate revenue of \$23MM. The difference between these numbers yields his “overcharge” of \$6.5 million.

Mr. Phillips’ analysis ignores the additional costs of paying debt that was used to build infrastructure to hook up with the MWRA system, engineering costs associated with running the system, administrative costs of managing the system, equipment maintenance costs associated with keeping the system operational, and other allocated expenses.

Should MWRA costs be excluded from allocations?

A portion of Mr. Phillips’ analysis is based on the assertion that MWRA costs are pure costs – since they simply represent a bill that is handed to the town by the MWRA. Mr. Phillips asserts that there is no justification for marking up these costs with allocated expenses.

However, MWRA costs represent 55-59% of the total costs of running Natick’s water and sewer services. If no allocated costs are added to the MWRA portion of the bill, then all of these costs would need to be allocated to the water and sewer portion of the bill – the remaining 41-45% of the bill.

We can illustrate this with the example of debt payments. Under current practice, with allocated debt payments added to the total bill (including MWRA charges), ratepayers are billed an additional \$20.00 for each \$100 to cover these debt payments. If the allocated debt payments were excluded

from the MWRA portion of the bill and merely allocated to the water and sewer portion of the bill, then an additional \$45.00 would be added to each \$100 of water and sewer charges to cover debt payments. See Table 2 at the back of this document for a complete analysis.

Mr. Phillips' analysis uses numbers out of the full context of providing water and sewer services to ratepayers in the Town of Natick. Water and sewer services cannot be maintained without paying down debt, providing engineering services, and using other resources that are not directly appropriated out of the DPW water and sewer budgets. Therefore these costs must be allocated to the direct costs and the most practical method to apply allocated costs are over the full portion of the bill, including MWRA charges which make up the largest portion of direct costs.

Mr. Phillips draws the erroneous conclusion that rate payers were "overcharged" by 36.7% for the delivery of MWRA connection services, as if these services could exist without collecting money to pay for the rest of the infrastructure needed to handle the Town's sewage, debt payment, management, engineering, and other functions.

The bottom line is that rate-payers do pay for more than the direct cost of providing water and sewer services. They pay for the debt service, engineering services, maintenance services, and other functions which keep the water and sewer system running and which are not directly charged to DPW departmental expenses. This has been a standing practice which has been formalized by the decision of the Town Administration, voted and approved by Town Meeting, to create a water and sewer enterprise fund.

No relation to alleged \$15.9 million number

In summary, Mr. Phillips' allegations of a \$36.70 or \$37.12 "overcharge" for every \$100 of MWRA billings, leading to his estimate of \$6.5 or \$6.6 million being overcharged from 2000-2004, is simply a disagreement over the proper policy for allocating indirect costs such as debt service, engineering services, maintenance, and other functions related to operating the water and sewer services of the town. Mr. Phillips does not believe these charges should be added to MWRA assessments. That does not mean, however, that these costs would not need to be added to some other portion of the water and sewer bill if they were not allocated to the MWRA portion of the bill.

There is no relationship between the \$6.5 or \$6.6 million "overcharge" alleged in this memo and Mr. Phillips' allegation of a \$15.9 million surplus fund balance which we have shown was the result of a miscalculation.

The Town of Natick has retained an auditing firm to review matters related to the creation of the water and sewer enterprise fund, including a review of the allocations used to charge for indirect costs. We expect any issues related to specific levels of allocated costs will be addressed in that report.

Table 4: Analysis of Town of Natick Water and Sewer Expenses FY98-FY02

Direct Costs	Expenses					Percent of All Direct Costs				
	FY98	FY99	FY00	FY01	FY02	FY98	FY99	FY00	FY01	FY02
Water Service	1,412,888	1,481,114	1,559,853	1,529,157	1,707,251	24.0%	24.7%	25.2%	25.0%	27.1%
Sewer Service	830,242	890,695	798,932	1,004,109	1,044,861	14.1%	14.9%	12.9%	16.4%	16.6%
MWRA Service	3,494,315	3,450,689	3,653,270	3,402,225	3,398,198	59.3%	57.7%	59.1%	55.7%	54.0%
Utility Billing Collector	158,018	162,906	167,945	173,140	143,084	2.7%	2.7%	2.7%	2.8%	2.3%
Subtotal Direct Costs	5,895,463	5,985,404	6,180,000	6,108,631	6,293,394	100.0%	100.0%	100.0%	100.0%	100.0%
Allocations										
Debt Service	1,095,272	1,166,629	1,269,844	1,405,193	1,307,261	18.6%	19.5%	20.5%	23.0%	20.8%
Equipment Maintenance	337,148	340,818	387,064	388,469	391,038	5.7%	5.7%	6.3%	6.4%	6.2%
Engineering Services	163,384	204,753	211,574	221,722	233,359	2.8%	3.4%	3.4%	3.6%	3.7%
DPW Administration	167,567	173,854	180,454	189,967	171,565	2.8%	2.9%	2.9%	3.1%	2.7%
Building Maintenance	98,095	116,537	125,057	155,882	158,946	1.7%	1.9%	2.0%	2.6%	2.5%
Highway Maintenance	142,206	136,888	148,367	146,160	140,970	2.4%	2.3%	2.4%	2.4%	2.2%
Fire	116,751	114,041	117,306	126,286	130,118	2.0%	1.9%	1.9%	2.1%	2.1%
Police	98,798	102,592	110,963	110,368	119,558	1.7%	1.7%	1.8%	1.8%	1.9%
Information Systems	54,562	84,839	79,059	79,340	117,841	0.9%	1.4%	1.3%	1.3%	1.9%
Community Development	70,287	69,144	75,099	81,912	84,221	1.2%	1.2%	1.2%	1.3%	1.3%
Assessing	65,826	72,442	61,716	62,510	74,895	1.1%	1.2%	1.0%	1.0%	1.2%
Town Administrator	58,294	68,662	69,450	72,205	60,897	1.0%	1.1%	1.1%	1.2%	1.0%
Reserve Fund	38,722	41,703	51,566	43,750	50,000	0.7%	0.7%	0.8%	0.7%	0.8%
Collector	43,802	46,680	46,668	47,993	49,478	0.7%	0.8%	0.8%	0.8%	0.8%
Legal Services	17,834	16,704	30,127	46,842	30,403	0.3%	0.3%	0.5%	0.8%	0.5%
Comptroller	21,639	28,771	24,258	27,082	29,123	0.4%	0.5%	0.4%	0.4%	0.5%
Property Insurance	23,201	24,433	20,327	30,887	27,663	0.4%	0.4%	0.3%	0.5%	0.4%
Treasurer (mgmt)	19,670	20,278	20,905	21,553	22,219	0.3%	0.3%	0.3%	0.4%	0.4%
Treasurer (less mgmt)	15,524	20,935	19,994	21,130	17,388	0.3%	0.3%	0.3%	0.3%	0.3%
Street Lighting	6,793	6,371	6,797	6,720	7,311	0.1%	0.1%	0.1%	0.1%	0.1%
Annual Report	555	563	563	563	1,189	0.0%	0.0%	0.0%	0.0%	0.0%
Finance Committee	802	665	658	603	459	0.0%	0.0%	0.0%	0.0%	0.0%
Emergency Management	22	22	22	22	22	0.0%	0.0%	0.0%	0.0%	0.0%
Personnel Board	196	188	0	25	0	0.0%	0.0%	0.0%	0.0%	0.0%
Subtotal Allocated Costs	2,656,950	2,858,512	3,057,838	3,287,184	3,225,924	45.1%	47.8%	49.5%	53.8%	51.3%
Total All Costs	8,552,413	8,843,916	9,237,838	9,395,815	9,519,318	145.1%	147.8%	149.5%	153.8%	151.3%

Source: Bob Palmer presentation to Budget and Planning Subcommittee of the Natick Finance Committee 8/4/05

Table 5: Analysis of Town of Natick Water and Sewer Expenses FY98-FY02

Direct Costs	Expenses					Percent of Water and Sewer Only				
	FY98	FY99	FY00	FY01	FY02	FY98	FY99	FY00	FY01	FY02
Water Service	1,412,888	1,481,114	1,559,853	1,529,157	1,707,251	58.8%	58.4%	61.7%	56.5%	59.0%
Sewer Service	830,242	890,695	798,932	1,004,109	1,044,861	34.6%	35.1%	31.6%	37.1%	36.1%
MWRA Service	3,494,315	3,450,689	3,653,270	3,402,225	3,398,198					
Utility Billing Collector	158,018	162,906	167,945	173,140	143,084	6.6%	6.4%	6.6%	6.4%	4.9%
Sub-Total Direct Costs	5,895,463	5,985,404	6,180,000	6,108,631	6,293,394					
Sub-Total Direct Costs Excluding MWRA	2,401,148	2,534,715	2,526,730	2,706,406	2,895,196	100.0%	100.0%	100.0%	100.0%	100.0%
Allocations										
Debt Service	1,095,272	1,166,629	1,269,844	1,405,193	1,307,261	45.6%	46.0%	50.3%	51.9%	45.2%
Equipment Maintenance	337,148	340,818	387,064	388,469	391,038	14.0%	13.4%	15.3%	14.4%	13.5%
Engineering Services	163,384	204,753	211,574	221,722	233,359	6.8%	8.1%	8.4%	8.2%	8.1%
DPW Administration	167,567	173,854	180,454	189,967	171,565	7.0%	6.9%	7.1%	7.0%	5.9%
Building Maintenance	98,095	116,537	125,057	155,882	158,946	4.1%	4.6%	4.9%	5.8%	5.5%
Highway Maintenance	142,206	136,888	148,367	146,160	140,970	5.9%	5.4%	5.9%	5.4%	4.9%
Fire	116,751	114,041	117,306	126,286	130,118	4.9%	4.5%	4.6%	4.7%	4.5%
Police	98,798	102,592	110,963	110,368	119,558	4.1%	4.0%	4.4%	4.1%	4.1%
Information Systems	54,562	84,839	79,059	79,340	117,841	2.3%	3.3%	3.1%	2.9%	4.1%
Community Development	70,287	69,144	75,099	81,912	84,221	2.9%	2.7%	3.0%	3.0%	2.9%
Assessing	65,826	72,442	61,716	62,510	74,895	2.7%	2.9%	2.4%	2.3%	2.6%
Town Administrator	58,294	68,662	69,450	72,205	60,897	2.4%	2.7%	2.7%	2.7%	2.1%
Reserve Fund	38,722	41,703	51,566	43,750	50,000	1.6%	1.6%	2.0%	1.6%	1.7%
Collector	43,802	46,680	46,668	47,993	49,478	1.8%	1.8%	1.8%	1.8%	1.7%
Legal Services	17,834	16,704	30,127	46,842	30,403	0.7%	0.7%	1.2%	1.7%	1.1%
Comptroller	21,639	28,771	24,258	27,082	29,123	0.9%	1.1%	1.0%	1.0%	1.0%
Property Insurance	23,201	24,433	20,327	30,887	27,663	1.0%	1.0%	0.8%	1.1%	1.0%
Treasurer (mgmt)	19,670	20,278	20,905	21,553	22,219	0.8%	0.8%	0.8%	0.8%	0.8%
Treasurer (less mgmt)	15,524	20,935	19,994	21,130	17,388	0.6%	0.8%	0.8%	0.8%	0.6%
Street Lighting	6,793	6,371	6,797	6,720	7,311	0.3%	0.3%	0.3%	0.2%	0.3%
Annual Report	555	563	563	563	1,189	0.0%	0.0%	0.0%	0.0%	0.0%
Finance Committee	802	665	658	603	459	0.0%	0.0%	0.0%	0.0%	0.0%
Emergency Management	22	22	22	22	22	0.0%	0.0%	0.0%	0.0%	0.0%
Personnel Board	196	188	0	25	0	0.0%	0.0%	0.0%	0.0%	0.0%
Sub-Total Allocated Costs	2,656,950	2,858,512	3,057,838	3,287,184	3,225,924	110.7%	112.8%	121.0%	121.5%	111.4%
Total	\$ 8,552,413	\$ 8,843,916	\$ 9,237,838	\$ 9,395,815	\$ 9,519,318					

Source: Bob Palmer presentation to Budget and Planning Subcommittee of the Natick Finance Committee 8/4/05